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REVIEW OF THE DEPARTMENT OF GENERAL
SERVICES' UNNECESSARY ACCUMULATION OF
ADDITIONAL WORKING CAPITAL

JANUARY 1974

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January 28, 1974

The Honorable President of the Senate
The Honorable Speaker of the Assembly
The Honorable Members of the Senate and the
Assembly of the Legislature of California

Members:

Transmitted herewith is the Auditor General's report pertaining to the Department of General Services' policy of accumulating additional working capital.

In the fiscal year 1972-73, the Department initiated a policy of charges in excess of cost for supplies and services to state agencies and its other customers.

From July 1, 1972 through November 30, 1973, such charges amounted to \$7.3 million and it is estimated that these charges for the fiscal year 1973-74 will amount to \$1.8 million. The Governor's Budget for fiscal year 1974-75 includes an additional \$3.2 million for these charges.

By June 30, 1979, the Department plans to have accumulated \$21 million from such charges. This accumulation policy of charges in excess of cost has not been authorized by the Legislature.

The Auditor General found that the cash advance system authorized by Section 11257 of the Government Code provides for sufficient working capital from customers to the Department of General Services. This system provides General Services with the cash necessary to pay for the supplies and services ordered during the 75 to 90 day lag time prior to receiving payment from its customers. When the \$21 million is accumulated, the Department plans to eliminate the cash advance system. In the Auditor General's judgment, the policy of charges in excess of cost for supplies and services to General Services' customers is a policy which is unnecessary and is not in the best interests of the state.

The Honorable Members of the
Legislature of California
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The Auditor General has made the following recommendations:

- (1) That the Department of General Services discontinue its policy of charging its customers amounts in excess of cost for supplies and services procured by its customers.
- (2) That the Department of General Services return to the Funds from which such monies were appropriated all charges accumulated in excess of cost for the supplies and services procured by its customers; these charges totaled \$7.3 million from July 1, 1972 through November 30, 1973, and an additional \$1.8 million is estimated through June 30, 1974.
- (3) That the Legislature consider reducing the customers' pending 1974-75 budgets by \$3.2 million contained in these budgets for General Services' charges in excess of cost for supplies and services.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Vincent Thomas", with a long horizontal flourish extending to the right.

VINCENT THOMAS, Chairman
Joint Legislative Audit Committee

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SUMMARY OF FINDINGS,
RECOMMENDATIONS AND SAVINGS

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FINDINGS

UNNECESSARY CHARGES IN EXCESS
OF COST FOR SUPPLIES AND SERVICES

Unnecessary charges in excess of cost have been made by the Department of General Services to state agencies and other customers of the department for supplies and services procured from the Department of General Services. Starting in fiscal year 1972-73, the department initiated charges to its customers in excess of cost for supplies and services in order to build up additional working capital of \$21 million by June 30, 1979. The Legislature has not approved of the department's policy of such charges in excess of cost which as of November 30, 1973 amount to \$7.3 million.

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RECOMMENDATIONS

We recommend that the Department of General Services immediately:

1. Discontinue its policy of charging its customers amounts in excess of cost for supplies and services procured by its customers.
2. Return to the Funds from which such monies were appropriated all charges accumulated in excess of cost for the supplies and services procured by its customers; these charges totaled \$7.3 million from July 1, 1972 through November 30, 1973 and an additional \$1.8 million is estimated through June 30, 1974.

We recommend that the Legislature consider:

3. Reduction in the customers' pending 1974-75 budgets by \$3.2 million contained in these budgets for General Services' charges in excess of cost for supplies and services.

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SAVINGS

The above recommendations, if properly implemented, will result in cash savings of at least \$12.3 million.

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INTRODUCTION

In response to a legislative request to conduct a management audit of the Department of General Services, we have concluded our review pertaining to the department's policy initiated in fiscal year 1972-73 to obtain additional working capital for the Service Revolving Fund.

The Legislature, in 1963, created the Department of General Services to centralize the business management functions and services in state government.

The department, through the Service Revolving Fund, provides supplies and services to state and other public agencies. The department's customers are billed for such supplies and services. To provide these supplies and services, the Service Revolving Fund needs cash for the purchase of materials, supplies, and equipment and for the payment of salaries, wages, and other expenses until such time as it can recover its costs through collection from the client agencies. For this purpose, Section 11257 of the Government Code authorizes the director to obtain cash advances from its customers as follows:

"State agencies may provide for the advancing of funds as herein provided to defray the charges mentioned in Section 11256. Any state agency may, and upon order of the Director of General Services shall, authorize such advances from any fund or appropriation available to it for payment for work, services, materials, or equipment to the fund or appropriation of the state agency which is to perform such work or render such services or furnish any materials or equipment to it, an amount equal to the estimated charges therefor or in an amount determined by the Director of General Services, and the State Controller shall transfer any amounts so authorized or determined."

FINDINGS

UNNECESSARY CHARGES IN EXCESS
OF COST FOR SUPPLIES AND SERVICES

Unnecessary charges in excess of cost have been made by the Department of General Services to state agencies and other customers of the department for supplies and services procured from the Department of General Services. Starting in fiscal year 1972-73, the department initiated charges to its customers in excess of cost for supplies and services in order to build up additional working capital of \$21 million by June 30, 1979. The Legislature has not approved of the department's policy of such charges in excess of cost which as of November 30, 1973 amount to \$7.3 million.

The Department of General Services initiated a policy in fiscal year 1972-73 of charging its customers amounts in excess of the department's cost for supplies and services procured by its customers. Such charges are for the purpose of accumulating additional capital in the department's Service Revolving Fund. The amounts in excess of cost were built into the billing rates set by the department. These rates not only reimburse the department for its direct and indirect cost of services and depreciation, but also include a factor for accumulating additional working capital.

According to General Services' financial statements, from July 1, 1972 through November 30, 1973, these charges in excess of cost amounted to \$7.3 million. We estimate that additional charges in excess of cost for the remainder of fiscal year 1973-74 will amount to \$1.8 million. The Governor's proposed budget for fiscal year 1974-75 includes \$3.2 million for these additional charges in excess of cost. Therefore, the total estimated amount of such charges in excess of cost from July 1, 1972 through June 30, 1975 is \$12.3 million.

The department intends to continue the policy of charges in excess of cost until an estimated \$21 million of additional working capital will be accumulated. It is estimated this will occur by June 30, 1979.

Primary Reasons For
Charges in Excess of Cost

Departmental officials stated that the primary reason for initiating the policy of charges in excess of cost was to eliminate the cash advance system as of July 1, 1979, when it is estimated that the department will achieve its objective of accumulating \$21 million in working capital.

The Director of General Services wants to abolish the cash advance system as it does not meet with his business philosophy. He pointed out that allowing a manager to fund services from cash advances is a poor business practice. It requires a customer to commit funds without directly receiving a product or a service. This removes some customer control in assessing value received. The director stated that the department's customers are less likely to complain to General Services regarding unsatisfactory supplies and services because advances for such supplies and services are made prior to their receipt. Therefore, he stated that General Services cannot always take corrective actions since customer input is lacking. He stated that when the cash advance system is abolished, the department's customers will have more of an incentive to register complaints since they will not pay General Services for the supplies and services until after they have been rendered. Further, the director stated that a system of billing customers for supplies and services including charges in excess of cost will encourage customers to consider alternative sources of supply and could, therefore, result in further economies.

In our judgment, the customers, if willing, are in a sound position to register complaints to General Services whether they advance funds for the supplies and services procured before their receipt as they now do under the cash advance system or make payments after their receipt which they would do if the cash advance system is abolished. Further, in our judgment, customers can consider alternative sources of supplies, as suggested by the director, whether or not they are billed at cost or at charges in excess of cost.

Cash Advance System

Currently, the cash advance system, authorized by Section 11257 of the Government Code, provides the working capital for the Service Revolving Fund. Since the department must pay its bills (payroll and other expenditures) on a timely basis, a source of cash is needed during the lag time before payment is received from its customers. This lag time varies from 75 to 90 days. This source of cash is provided by the cash advance system.

Under the cash advance system, the department requires its customers to estimate annually their anticipated expenditures for supplies and services. The State Controller makes systematic advances to the Service Revolving Fund as requested by the Department of General Services.

The Chief of Administrative Services stated that \$18 million of the \$21 million of the additional working capital will be used to replace the cash advance system in order to cover the expenditures during the average 75 to 90 day lag time between the General Services delivery of supplies and services and the customer payments to General Services.

We found that the cash advance system has operated satisfactorily in that:

- At no time during fiscal years 1971-72 and 1972-73 under the cash advance system did the department experience a deficit in its cash position.
- Pursuant to Government Code Section 11257, the Director of General Services can legally require sufficient cash advances to cover the cost of goods and services ordered. Customers can only order such goods and services from General Services in amounts previously appropriated for that purpose in their budgets, or approved in subsequent augmentations or line item transfers. If General Services encounters unusual problems, additional cash can be requested through the Department of Finance.

Other Purposes for which The
Additional Working Capital Is To Be Used

The Chief of Administrative Services stated that \$3 million of the \$21 million of additional working capital is to be used by General Services to:

- Fund additional equipment purchases, and
- Provide initial funding for expansions of existing state programs.

Under established budgetary procedures, the department can and should request appropriations from the Legislature for meeting these noncurrent operating costs without the necessity for accumulating working capital by charges to its customers in amounts in excess of cost.

While we believe the Director of General Services is genuinely interested in making state government operate efficiently, effectively and economically, in our judgment, the policy of charges for goods and services in excess of cost to General Services' customers for additional working capital is a policy which is unnecessary and is not in the best interests of the state. These charges in excess of cost while not identified as such have been appropriated in the budgets of the state agencies and other customers of the Department of General Services.

We recommend that the Department of General Services immediately:

1. Discontinue its policy of charging its customers amounts in excess of cost for supplies and services procured by its customers.
2. Return to the Funds from which such monies were appropriated all charges accumulated in excess of cost for the supplies and services procured by its customers; these charges totaled \$7.3 million from July 1, 1972 through November 30, 1973 and an additional \$1.8 million is estimated through June 30, 1974.

We recommend that the Legislature consider:

3. Reduction in the customers' pending 1974-75 budgets by \$3.2 million contained in these budgets for General Services' charges in excess of cost for supplies and services.

These recommendations, if properly implemented, will result in cash savings of at least \$12.3 million.

The Chief of Administrative Services stated that only \$1.3 million in cash remained of the \$4.5 million excess charges accumulated as of June 30, 1973. Therefore, he stated that even if he wanted to return these funds, he only had \$1.3 million in cash with the balance already used to purchase equipment and inventories. As of November 30, 1973, the charges in excess of cost amounted to \$7.3 million. We believe the return of the entire \$7.3 million and any additional accumulations in fiscal year 1973-74 can be effected from cash advance payments into the Service Revolving Fund.

Legality of Additional
Working Capital Accumulation

There has been no legislative authorization in fiscal years 1972-73 and 1973-74 for the accumulation policy through charges in excess of cost of the additional working capital for the Department of General Services. The Chief of Administrative Services stated that the department will take steps to have the policy reviewed and authorized by the Legislature.

We requested from departmental officials the legal authority for including an overcharge factor that will result in the accumulation of \$21 million of additional working capital. A letter dated December 4, 1973, from the department's legal office to the director stated:

"... If you can conclude that the pro rata share of working capital is a concept which appropriately can be included within the definition of 'cost', then Section 11290 of the Government Code specifically permits us to recoup it. However, it appears that the system to be used and the principles of accounting involved should be carefully identified and should be submitted for review by the Department of Finance, with respect to State accounting systems. A good method by which the acceptability of the plan by the State, both legally and policy-wise, can be reviewed, is to specifically include reference and description of the rate recovery procedure in the budget presented by this Department."

The director stated that since Section 11290 gives him the discretion to define cost, he has elected to include in the department's charges a factor for accumulating working capital as a cost in addition to factors for the direct and indirect cost of supplies and services.

We also requested a legal opinion from the Office of the Legislative Counsel concerning the legality of the department's plan to build up a working capital through charges in excess of cost. The legal opinion states:

- The overcharge "...represents an advance collection of funds for future purchases...".
- "...Advance charges for intergovernmental services must be based upon 'cost'...".
- "...'cost', as used in (Government Code) Section 11257 and 11290, refers to actual cost or amounts actually to be expended and does not include any profit factor...".

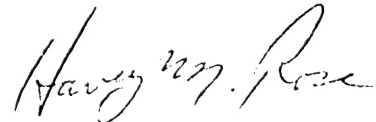
The opinion adds that:

"There is no authority in state law for conducting such activities (intergovernmental services) on a profit basis. To do so,...would merely involve a shifting of taxpayers' dollars around state government with no net gain or benefit to the public and probably result in the expenditure of funds for the purpose other than that for which they have been appropriated in violation of Section 21 of Article XIII of the Constitution".

Moreover, in previous instances when the Legislature has been specifically faced with the question of accumulating working capital, it has placed limitations on such accumulations. Under Section 19 of the Budget Act,

surplus in excess of \$6.5 million in 1972-73 and \$6.9 million in 1973-74 accumulated in the Service Revolving Fund for the Office of State Printing is to be transferred to the General Fund. Additionally, Section 16422 of the Government Code requires that any rental receipts paid into the Service Revolving Fund in excess of rental payment and the cost of maintaining, operating and insuring building space shall be credited to the General Fund as revenue. For fiscal year 1972-73, excessive rental receipts of \$2 million were transferred to the General Fund.

It should also be noted that the department's policy of charges in excess of cost may jeopardize some federal funds. Bureau of the Budget Circular A-87 states that the federal government will not reimburse the state for any provision for profit or other increment above cost.



Harvey M. Rose
Auditor General

January 23, 1974

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